Economic Update

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Volume 1, Number 3 11 July 2002

Data Still Point to Moderate Economic Growth

Declines in the stock market and in the exchange value of the dollar in recent weeks have revealed a high degree of uncertainty in financial markets, raising concerns about the sustainability of the economic recovery. At the same time, the private forecast consensus for real gross domestic product [GDP] growth in the second quarter has slipped to just above 2½ percent at an annual rate, a bit lower than earlier projections had indicated and significantly slower than the 6.1-percent rate of growth in the first quarter.

Nevertheless, incoming data on real, inflation-adjusted, spending and production in the U.S. economy continue to point to a moderate pace of economic growth. The private Blue Chip consensus, released this week, still expects real GDP to grow in the range of about 3¼ percent to 3¾ percent at an annual rate for the remainder of this year and through 2003 (see table below).

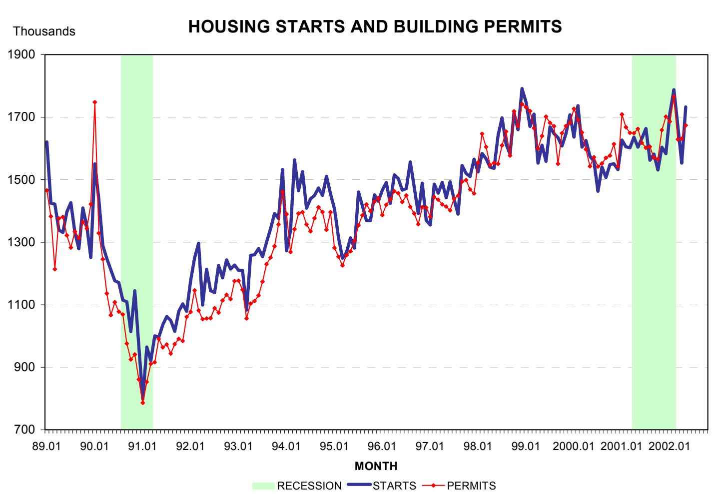
Blue Chip Economic Outlook, July 2002

	2002.2	2002.3	2002.4	2003 Avg.
	(percent)			
Real GDP Growth	2.6	3.3	3.7	3.6
Unemployment Rate	5.9	5.9	5.8	5.5
CPI Inflation	3.3	2.3	2.4	2.5
3-month Treasury Bill	1.7	1.9	2.2	3.2
10-year Treasury Note	5.1	5.1	5.3	5.7

Continued Evidence of Moderate Growth

Employment: Labor markets continue to recover slowly from the recession. The unemployment rate for June was 5.9 percent, largely unchanged from May and April, but higher than the 5.6-percent average for the first quarter. Nonfarm payroll employment showed a modest increase of 36,000 jobs in June following a gain of just 24,000 in May. Even smaller increases occurred in private payrolls – 13,000 in June and 7,000 in May. Still, these were the first gains since the beginning of the recession in March 2001. That, along with a downward trend in initial claims for unemployment insurance in recent months, provide some evidence of improvement in the labor market. But further improvement is likely to come slowly. This is mainly due to high productivity growth, and because GDP growth is expected to remain at, or only slightly above, the economy's non-inflationary, "potential" growth rate (as discussed in previous issues of *Economic Update*).

Consumption and Residential Investment: Recent data point to slower growth in consumer spending, with real personal consumption expenditures likely rising at an annual rate of about 1½ percent in the second quarter, down from the nearly 5-percent annual rate of increase during the prior two quarters. Various forces are at work, but two notable factors are having opposing effects on consumption through household wealth: declines in the stock market and increasing



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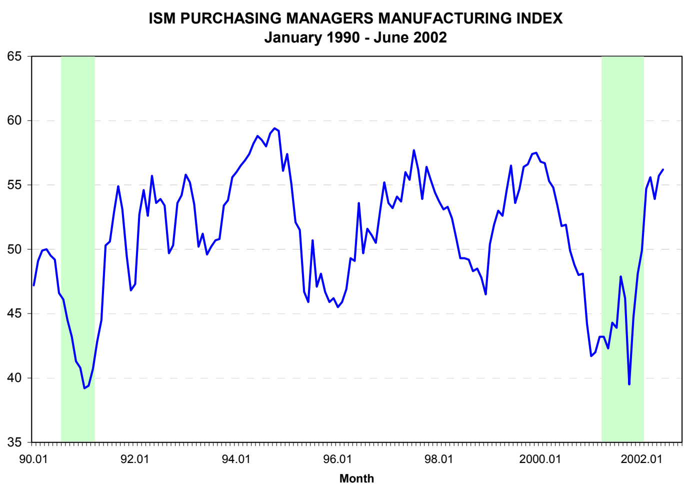
values of residential real estate (these relationships are discussed in more detail below). The recent ongoing strength in residential real estate markets is illustrated by the continued high level of housing starts and building permits (see chart on the previous page). The continued strong housing market during the recent recession contrasts sharply with the typical large decline in residential investment during recessions.

Manufacturing and Investment: The recovery in manufacturing and investment still appears to be on track. The Institute for Supply Management's purchasing managers' index – a key measure of the performance of the manufacturing sector – increased to 56.2 in June (a reading above 50 indicates an expanding manufacturing sector), its highest level in more than 2 years (see chart below). Manufacturing industrial production and orders and shipments for manufacturer's durable goods continued on their upward trends through May. Data for shipments of nondefense capital goods and other indicators suggest that real business investment spending for equipment and software likely grew in the second quarter – which would be the first solid gain in more than a year and a half.



The Decline in the Stock Market: A Drag on the Real Economy?

The recent declines in the stock market may act as a drag on consumption and investment spending in the economy, but those effects likely would not be of sufficient size to derail the economic recovery. Changes in the value of stocks have an effect on consumption spending through changes in the corporate equity and mutual funds components of household wealth. Typical estimates of the impact of changes in wealth on spending are relatively small, indicating that consumption spending changes by only about 3 percent to 5 percent of the change in the value of stock market wealth. According to Federal Reserve statistics, the value of corporate equity and mutual funds held by households and nonprofit organizations fell by about $4 trillion (about a 30-percent decline) from the stock market peak at the end of the first quarter of 2000 through the first quarter of this year. Partially offsetting that effect, however, was a $2-trillion increase in the value of household real estate. Hence, the net decline in household wealth – and its impact on consumption – represents only a fraction of the decline in the stock market. Also, despite the declines in stocks from their peak in 2001, longer-run gains have been substantial: over the past 10 years, holdings of corporate equities and mutual funds (excluding pensions and life insurance reserves) had increased by more than $5 trillion (nearly tripling in value) and the value of household real estate had also increased by more than $5 trillion (nearly doubling).

The stock market decline may, at the margin, slow business investment as a result of reduced investor confidence and business concerns about corporate financial positions. But fundamentals remain good for investment: the corporate profit outlook is improving, interest rates are low, investment tax incentives are in place, and the outlook for business' sales is improving. Hence, the primary determinants of investment spending – cash flow, user cost of capital, and demand for the final product – are improving and pointing to likely ongoing increases in real business investment.

Nevertheless, some uncertainty remains: there has been little experience with stock declines of the magnitude observed recently from the excessive overvaluations of the late 1990s.

Upcoming GDP Revisions

At the end of July the Commerce Department will release revised data for the past 3 years for the National Income and Product Accounts [NIPAs], including real GDP and aggregate national income measures. It is not certain what the revisions will show, but recent government estimates for State personal income for 2001 reveal that NIPA measures of personal income for 2001 will be revised down, perhaps by $90 billion or more (see *Survey of Current Business*, Bureau of Economic Analysis, May 2002). The revised data may also show the recession – in terms of the decline in real GDP – was worse than currently estimated, at -0.3 percent. Downward revisions to income and real GDP estimates would help to better explain some recent developments, including the sharp (and currently unexplained) fall in tax receipts and the extent of the increase in the unemployment rate. *But it should be stressed that these are historical data, with no direct impact on estimates of future growth.*